

Modification proposal:	<b>Balancing and Settlement Code (BSC) P274: Cessation of Compensatory Adjustment</b>		
Decision:	The Authority <sup>1</sup> has decided to reject this proposal and its alternative		
Target audience:	National Grid Electricity Transmission Plc (NGET), Parties to the BSC and other interested parties		
Date of publication:	29 January 2013	Implementation Date:	n/a

## Background to the modification proposal

Settlement is the process for comparing the amount of energy that an electricity supplier has arranged to be put on to the network with the amount that their customers have consumed. This calculation is made for each settlement period (defined as a period of 30 minutes). For the purposes of settlement, energy allocated to suppliers as consumption is summed by Grid Supply Point (GSP) Group.<sup>2</sup> Where a supplier is unable to match its allocated consumption and its energy purchases, it will be required to pay "imbalance charges" to reflect the costs incurred by the System Operator in balancing the system.<sup>3</sup> Settlement arrangements are contained in the Balancing and Settlement Code (BSC).

The majority of sites do not have meters capable of recording consumption in each half hour of the day. These sites are settled non-half-hourly (NHH) using periodic, manual meter reads taken over extended periods. Profiling techniques are used to convert these reads into half-hourly consumption values.

The settlement calculation is repeated at set intervals called reconciliation runs. The final reconciliation run (RF) occurs 14 months after real time. At this point, consumption volumes are 'crystallised' and cannot be changed unless a party raises a trading dispute.<sup>4</sup> However, suppliers can use a mechanism called Gross Volume Correction (GVC) to compensate for errors. GVC works by adjusting consumption volumes for settlement periods not yet subject to RF by the amount of energy that was lost or gained because of errors in volumes that are now crystallised. The span of time over which a site was settled on incorrect consumption volumes that have crystallised is called the 'error period'. The period during which GVC is used to compensate for inaccuracies is called the 'compensation period'.

Use of GVC has implications for the allocation of consumption volumes. While the gross volume of energy settled will be accurate, the volumes allocated to each settlement period will be wrong.

When a supplier applies GVC to a particular site, this will affect other suppliers active in the GSP Group where this site is located. This is due to the application of GSP Group Correction Factors (GGCFs). GGCFs scale all suppliers' consumption volumes up or down to ensure the amount of energy entering a GSP Group matches the amount that is allocated. During the error period, if the energy allocated to a site is more or less than is

<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> A Grid Supply Point (GSP) is a point of connection from the electricity transmission system to a distribution network, large power station or non-embedded consumer. These are grouped into 14 GSP Groups for settlement purposes.

<sup>3</sup> The System Operator is the entity charged with operating the electricity transmission system in Great Britain.

<sup>4</sup> If a trading dispute is upheld, another reconciliation run (called a DF run) will be undertaken when the correct consumption volumes become available. Any DF run must happen within 28 months of real time.

actually used, GGCFs will decrease or increase respectively the consumption volumes of other suppliers (assuming all other sites are allocated the correct amount of energy and taking into account energy lost from the network). If subsequently the supplier applies GVC to adjust the actual volumes for a site up or down, the amount of energy allocated to other suppliers will be decreased or increased respectively to address the excess or shortfall.

The adjustment of energy volumes due to application of GVC will have financial implications for all suppliers. This will depend on each supplier's contracted and metered volumes, as well as the market price of energy and the price of imbalance charges in each half hour during the error and compensation periods.

### **The modification proposal**

In September 2011, Electricity North West Limited (the proposer) raised BSC P274. In raising P274, the proposer argued that use of GVC could inhibit effective competition because:

- it can result in new entrants having volumes attributed to them that relate to periods before they started trading, which may deter entry
- it leads to suppliers having volumes attributed to them that relate to cheaper or more expensive wholesale energy prices
- it can result in distribution network operators being unable to produce suitable forward-looking Line Loss Factors for settlement, as these are based on historical settlement data.<sup>5</sup>

The proposer also argued that the introduction of smart meters could result in the identification of previously undetected errors, thus increasing the use of GVC.

To address these concerns, the proposer raised P274 with the intention of removing the use of GVC. However, during the modification process the original proposal was revised such that it would restrict, but not prohibit, the use of GVC. The workgroup responsible for developing the proposal also raised an alternative. The P274 proposal and alternative were submitted to Ofgem in December 2012.

#### *Proposed solution*

The proposed solution would introduce a definition of GVC in the BSC and impose two limits on its use. First, it would prevent suppliers from using GVC where the volume of energy they are seeking to compensate for (the Compensatory Volume) is:

- greater than twice the GSP Group Profile Class Default Estimated Annual Consumption (EAC)<sup>6</sup>, or
- greater than a Compensatory Volume Threshold at the point of assessment. This threshold would be determined by a committee of the BSC Panel called the Supplier Volume Allocation Group (SVG).

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<sup>5</sup> Line Loss Factors are used to adjust metered volumes to take account of losses on distribution networks.

<sup>6</sup> When no meter reading is available for a site it is settled using an estimate of annual consumption. This is called an EAC and is based on historical data.

Where the Compensatory Volume exceeds either of these limits, suppliers would be required to address errors using a non-compensatory correction technique called "Re-initialisation". This would mean that a site is settled on the correct consumption volumes for all settlement periods that are not yet subject to RF. As a result, suppliers would not be able to compensate for earlier errors in consumption volumes.

The proposed solution would also introduce a time limit on the application of GVC. As a result, suppliers can only use GVC to compensate for errors that fall within 28 months of real time. Finally, it would also require suppliers to maintain an audit trail for GVC.

#### *Alternative proposal*

During the assessment process, the workgroup developed an alternative proposal. This would introduce a definition of GVC and limits its use to volumes within a defined period. Initially suppliers would be able to compensate for any errors in energy volumes for a period up to five years prior to the RF run at the time GVC is performed. The SVG would have the ability to approve changes to this time limit.

#### **BSC Panel<sup>7</sup> recommendation**

The Panel considered the P274 draft Final Modification Report (FMR) at its meeting on 13 December 2012. The Panel recommended that both the proposed solution and the alternative should be rejected.

#### **The Authority's decision**

The Authority has considered its statutory duties and functions in reaching its decision. The Authority has considered the issues raised by the modification proposal and the FMR dated 20 December 2012. The Authority has considered and taken into account the responses to Elexon's<sup>8</sup> consultations on the modification proposal that are attached to the FMR<sup>9</sup>.

The Authority has concluded that implementation of the modification proposal and its alternative will not better facilitate the achievement of the Applicable BSC Objectives of the BSC.<sup>10</sup> We have therefore decided to reject this proposal and its alternative. The following section sets out our assessment of both against the Applicable BSC Objectives.

#### **Reasons for the Authority's decision**

##### ***Objective c: promoting effective competition in the generation and supply of electricity, and (so far as consistent therewith) promoting such competition in the sale and purchase of electricity***

We have considered the proposer's arguments that GVC could inhibit competition when it is used to move around large volumes of energy. Energy allocation for NHH sites does not fully reflect actual usage, because half-hourly metered data is not available.

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<sup>7</sup> The BSC Panel is established and constituted pursuant and in accordance with Section B of the BSC.

<sup>8</sup> The role and powers, functions and responsibilities of Elexon are set out in Section C of the BSC.

<sup>9</sup> BSC modification proposals, modification reports and representations can be viewed on the [Elexon website](#).

<sup>10</sup> As set out in Standard Condition C3(3) of NGET's Transmission Licence, see:

<http://epr.ofgem.gov.uk/EPRFiles/Electricity%20transmission%20full%20set%20of%20consolidated%20standards%20licence%20conditions%20-%20Current%20Version.pdf>

However, GVC results in a supplier intentionally providing meter readings for a site to settlement that are incorrect during the compensation period. The outcome is that the estimates generated by the profiling process for each half hour during this period will be lower or higher than would otherwise have been the case.

The implications for competition arise through the application of GGCFs. All suppliers' volumes will be adjusted up or down during the compensation and error periods. Whether the suppliers who are not using GVC gain or benefit will depend on the interaction of their imbalance position and the prices paid during each half hour of the error and consumption periods. However, it is possible that they will incur costs that are outside of their control. The origins of this issue lie in a site being settled on an inaccurate meter reading during the error period. We note the arguments that this could have particular implications for smaller suppliers, particularly if they were not trading in a GSP Group during the error period.

Both the proposed and alternative solutions would introduce controls around use of GVC. The former in particular would increase the incentive on suppliers to identify and correct errors before RF. This may have positive effects on competition, as the proposed arrangements would help avoid smearing of the costs of errors across all suppliers.

However, we also note the argument of some members of the workgroup that it is not feasible always to ensure that sites are settled on accurate meter readings, especially within the limits that would be introduced by the proposed solution. These workgroup members argued that GVC is a legitimate mechanism that seeks to ensure the overall accuracy of settlement. In addition, some responses to consultation argued that GVC allows suppliers to recover costs they have incurred from errors in settlement data. It was suggested that this is especially relevant for smaller suppliers who value a means of compensating for errors.

The assessment process for this modification has highlighted the lack of transparency regarding how GVC is used. We note in particular that the Trading Disputes Committee<sup>11</sup> identified this as a significant issue. We also note the low number of responses to the information request issued by Elexon as part of the assessment process and the conflicting views on the quality of data submitted. In the absence of reliable data on the use of GVC, we are unable to judge the extent to which it may undermine competition by distorting the accuracy of settlement, nor whether the proposed and alternative solutions improve the baseline by introducing appropriate controls around its use. Therefore, we cannot conclude that the proposed solution or the alternative better facilitate the achievement of Applicable BSC Objective (c).

***Objective d: promoting efficiency in the implementation and administration of the balancing and settlement arrangements***

The proposed solution would introduce an audit trail to monitor the use of GVC, which would improve the industry's understanding of the impact of its use. However, the proposed solution would also add further complexity to the existing arrangements. There is also a risk that suppliers might respond to implementation of the proposal by raising more trading disputes to correct errors. Finally, the responses from some suppliers to the impact assessment indicated high implementations costs. As a case has not been made to demonstrate that the benefits of the proposed solution would outweigh the potential

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<sup>11</sup> The Trading Disputes Committee is a committee of the Panel responsible for resolving trading disputes and manifest errors so that the integrity of settlement maintained.

risk, costs and complexity, we conclude that it does not better facilitate the achievement of Applicable BSC Objective (d).

Like the proposal, the alternative introduces a mechanism for tightening controls on use of GVC. It would also be less complex and costly to implement. However, if we approved the alternative we would be accepting that at this time use of GVC does not undermine competition within the proposed time restrictions. On this point, we note the views of some members of the Panel that it would have a neutral impact on the use of GVC and hence may not address the potential issues described above. Given the absence of data, we cannot conclude that the restrictions on the use of GVC proposed by the alternative would better facilitate Applicable BSC Objective (d).

### **Additional comments**

The modification process has highlighted the potential impact that use of GVC can have on settlement accuracy and hence competition in the market. We also note that GVC has affected processes in other segments of the market that use settlement data, such as the losses arrangements for the distribution networks operators.

In the light of these issues, industry should put in place arrangements for monitoring use of GVC, with a view to introducing controls on its use if appropriate. We expressed similar views in the context of P176 in 2005 and are disappointed action was not taken at that time.<sup>12</sup> Going forward, we expect that the industry will work for a prompt implementation of appropriate monitoring arrangements (for example, through implementation of Change Proposal 1360 if appropriate).<sup>13</sup>

We also note that the roll out of smart meters presents an opportunity to improve the quality of the settlement arrangements. This includes the potential to avoid the need for complex mechanisms such as GVC. As part of Ofgem's Smarter Markets Programme, we are considering how longer-term reform of settlement arrangements can be progressed.<sup>14</sup>

**Colin Sausman**

**Partner – Retail Markets & Research**

**Signed on behalf of the Authority and authorised for that purpose.**

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<sup>12</sup> See P176 [Decision Letter](#) "Clarifications of the requirements for estimation/deeming of meter readings /advances in certain circumstances to facilitate correction of anomalies in settlement consumption".

<sup>13</sup> Change Proposal 1360 proposes to introduce audit obligations on suppliers in relation to the use of techniques such as GVC.

<sup>14</sup> Ofgem has established the Smarter Markets Programme to help drive the changes to market arrangements, including electricity settlement, that can help make retail markets work better for consumers from the platform of smart metering. Further information can be found on the Ofgem website.